

## Internal Revenue Service

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CC:PSI:B01

PLR-145462-07

Date: March 3, 2008

### LEGEND

X =

State =

A =

B =

Trust 1 =

Trust 2 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Month =

Dear

This responds to a letter dated October 4, 2007, and subsequent correspondence, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

#### FACTS

According to the information submitted, X was incorporated on Date 1 under the laws of State. X elected to be treated as an S corporation effective Date 2. Shares of X stock were transferred to Trust 1 on or about Date 3. Trust 1 was treated (under subpart E of part I of subchapter J of chapter 1 of the Internal Revenue Code) as owned by spouses A and B. Thus, Trust 1 was a permitted S corporation shareholder pursuant to § 1361(c)(2)(A)(i). Trust 1 consisted, in part, of the community property of A and B. The X stock held by Trust 1 was A's and B's community property. A died on Date 4. Upon A's death, the portion of Trust 1 of which B was the grantor / owner continued to qualify as a permissible S corporation shareholder under § 1361(c)(2)(A)(i). Pursuant to § 1361(c)(2)(A)(ii), A's portion of Trust 1 continued to be a permitted shareholder for the two-year period beginning on Date 4. A's portion of Trust 1 became an ineligible shareholder on Date 5.

Trust 1's agreement provides that, upon the death of either A or B, Trust 1's estate is to be divided into two separate shares: the decedent's share and the survivor's share (or survivor's trust). The survivor's trust is funded with assets consisting of the community and separate property of the survivor held in Trust 1 on the date of the decedent's death. The decedent's share is funded with assets consisting of the community and separate property of the decedent held in Trust 1 on the date of the decedent's death. The decedent's share is further divided into a decedent's trust (Trust 2) and a marital trust. On Date 6, X stock held by Trust 1 was distributed to Trust 2 and the survivor's trust. The survivor's trust continued to qualify as a permissible S corporation shareholder under § 1361(c)(2)(A)(i). Trust 1's remaining shares in X were distributed to an individual.

X represents that Trust 2 has at all times qualified to elect to be an electing small business trust (ESBT), within the meaning of § 1361(e), that no beneficiaries acquired an interest in Trust 2 by purchase, and that it was intended that an ESBT election be filed for Trust 2. In Month, X's counsel discovered that no ESBT election had been filed for Trust 2.

X represents that the failure to timely transfer Trust 1's stock in X to an eligible shareholder, and to timely file an ESBT election for Trust 2, was inadvertent and not motivated by tax avoidance or retroactive tax planning. X and its shareholders agree to make any adjustments required by the Secretary consistent with the treatment of X as an S corporation.

## LAW AND ANALYSIS

Section 1361(a)(1) provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for such year.

Section 1361(b)(1) defines a "small business corporation" as a domestic corporation that is not an ineligible corporation and that does not (A) have more than 100 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1361(c)(2)(A)(i) provides that, for purposes of § 1361(b)(1)(B), a trust all of which is treated (under subpart E of part I of subchapter J of chapter 1) as owned by an individual who is a citizen or resident of the United States may be a shareholder.

Section 1361(c)(2)(A)(ii) and § 1.1361-1(h)(1)(ii) provide that, for purposes of § 1361(b)(1)(B), a trust that is described in § 1361(c)(2)(A)(i) immediately before the death of the deemed owner and that continues in existence after such death is a permitted shareholder, but only for the two-year period beginning on the day of the deemed owner's death. Section 1.1361-1(h)(3)(i)(B) provides that if stock is held by a trust described in § 1.1361-1(h)(1)(ii), the estate of the deemed owner is generally treated as the shareholder as of the day of the deemed owner's death.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever the corporation ceases to be a small business corporation.

Section 1361(e) defines an ESBT. Section 1361(e)(1)(A) provides that, except as provided in § 1361(e)(1)(B), an ESBT means any trust if (i) the trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, (III) an organization described in § 170(c)(2), (3), (4), or (5), or (IV) an organization described in § 170(c)(1) that holds a contingent interest in the trust and is not a potential current beneficiary, (ii) no interest in the trust was acquired by purchase, and (iii) an election under § 1362(e) applies to the trust. Section 1361(e)(3) provides that an election under § 1361(e) shall be made by the trustee.

Section 1.1361-1(m)(2)(i) provides that the trustee of an ESBT must make the ESBT election by signing and filing, with the service center where the S corporation files its income tax return, a statement that meets the requirements of § 1.1361-1(m)(2)(ii). Section 1.1361-1(m)(2)(iii) provides that the ESBT election must be filed within the time requirements prescribed by § 1.1361-1(j)(6)(iii) for filing a qualified subchapter S trust election.

Section 1362(f) provides, in relevant part, that if (1) an election under § 1362(a) by any corporation was terminated under paragraph (2) or (3) of § 1362(d), (2) the Secretary determines that the circumstances resulting in such termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in termination, steps were taken so that the corporation is once more a small business corporation, and (4) the corporation and each person who was a shareholder of the corporation at any time during the period specified pursuant to § 1362(f), agrees to make any adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to the period, then, notwithstanding the circumstances resulting in the termination, the corporation will be treated as continuing to be an S corporation during the period specified by the Secretary.

## CONCLUSION

Based solely on the information submitted and the representations made, we conclude that X's S corporation election terminated on Date 5 when A's portion of Trust 1 became an ineligible S corporation shareholder and that the termination was inadvertent within the meaning of § 1362(f). Furthermore, if X's S election had not terminated on Date 5, it would have terminated on Date 6 when X shares were transferred to Trust 2, which was an ineligible shareholder because no ESBT election was filed for Trust 2. We further conclude that the failure to timely file an ESBT election for Trust 2 was inadvertent within the meaning of § 1362(f). Therefore, X will be treated as continuing to be an S corporation from Date 5, and thereafter, provided that the trustee of Trust 2 files an ESBT election for Trust 2 with the appropriate service center, effective Date 6, within 60 days of the date of this letter, and provided that X's S corporation election was otherwise valid and was not otherwise terminated under § 1362(d). A copy of this letter should be attached to the election.

Accordingly, the shareholders of X must include in income their pro rata share of the separately stated and nonseparately computed items of X as provided in § 1366, make any adjustments to basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368. This ruling is contingent upon X and each of its shareholders filing any amended returns and making such adjustments that are necessary to properly reflect the reporting of X's items of S corporation income.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed concerning whether X is otherwise eligible to be treated as an S corporation, or whether Trust 2 is eligible to be treated as an ESBT.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

/s/

Audrey W. Ellis  
Senior Counsel, Branch 1  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter

Copy of this letter for § 6110 purposes